TESTIMONY OF

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on

MERGING THE BANK INSURANCE AND SAVINGS ASSOCIATION INSURANCE FUNDS

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

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INTRODUCTION

Madam Chairwoman and Members of the Subcommittee, I appreciate and welcome this opportunity to testify before you today on the proposed merging of the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF).

I was similarly privileged to testify on this same topic before this same esteemed body in this same room some five years ago on March 24, 1995.

I have studied the FDIC for the last 35 years and have met with and testified before their Board of Directors in the past on issues related to the insurance funds. In fact, while a Wharton Ph.D. candidate, I was recruited by the FDIC for an economist position in the early seventies and have nothing but the greatest respect for that agency.

I have taught banking and economics as a Lecturer in Finance at The Wharton School every year since 1970, but I do not come here as an ivory tower academic. I have worked as a consultant to hundreds of banks and thrifts of all sizes throughout the nation since 1969, but I do not represent the views of the bank or thrift industries.

Those views have been well articulated by a previous panel, as have the views of the regulators. My goal is to attempt to represent the views of a third party, that of a taxpaying bank depositor.

As a lifelong student of the FDIC, I have collected virtually every one of their publications. In fact, the FDIC staff has contacted me on several occasions to lend them FDIC material from my library that they no longer had! The prized possession of my FDIC collection is a hardbound version of their first Annual Report in 1934.

Whenever I am conducting research on the FDIC and have a question as to what this agency is really about, I refer back to this 1934 document. It states very clearly (p. 7) in the introduction that the FDIC was "created to insure depositors against loss resulting from bank failures." Not to insure individual banks but depositors, so that they maintain confidence in the system. The focus should always be on bank depositors, and this is the perspective I am taking today.

In short, my goal is to present an independent view that will result in good public policy. In the case of the FDIC this means maintaining public confidence in banks through protecting depositors' accounts; promoting sound banking practices; reducing the disruptions caused by bank failures; and, responding to a changing economy and banking system.

EXECUTIVE SUMMARY OF RECOMMENDATIONS

This Subcommittee must be commended for having this hearing on such an essential issue. We are entering the new millenium with a template for a totally restructured financial services industry, yet there has been no restructuring of the relevant regulatory agencies or insurance funds. This Subcommittee, by putting these key issues out for debate, will allow the industry to move together with their regulatory and insuring bodies into this new financial services era.

My recommendations to this Subcommittee on the proffered questions regarding the insurance funds are identical to the recommendations made in my March 24, 1995 testimony here:

1. *The BIF and SAIF insurance funds should be merged ASAP.*

2. *The 1.25% statutory designated reserve ratio (DRR) should be increased to 1.50%.*

3. *There should be NO cap on the size of the merged fund.*

4. *Rebates should NOT be paid.*

5. *Good public policy in this area would also include the following:*

   A. *Merging of the OTS into the OCC.*

   B. *Explicit recognition of the "Too Big To Fail" (TBTF) policy in the form of a special assessment for TBTF banks.*

   C. *Significantly expanded market discipline, beginning with the public disclosure of some essential information on the safety and soundness condition of banks and thrifts.*

   D. *Significantly improved bank regulatory and supervisory discipline.*

   E. *Significantly improved disclosure of non–FDIC insured bank products.*

I should parenthetically point out that none of my above recommendations in 1995 were met with enthusiasm by the banking industry, but many members of this Subcommittee were quite open minded. My 1.50% proposal, for example, was endorsed by Representative LaFalce, despite the banking industry being "outraged" over it according to the front page of the March 27, 1995 *American Banker.* History will show that he demonstrated tremendous leadership and courage in this regard.

PRINCIPLES UNDERLYING THE BANK DEPOSITORS' VIEW

1. *The protection of bank depositors and the maintenance of public confidence in the banking system is more important than ever today with a volatile stock market fueled by day traders and high–flying IPOs.*

2. *The FDIC fund must NEVER be allowed to become insolvent again, even if by a GAO reserving "technicality," as was the case in 1991 and 1992.*

3. *Taxpayers and the government's "full faith and credit" guarantee not financial institutions ultimately stand behind the federal deposit insurance system, but the banking industry will always take the opposite view that they financed their "own" insurance fund.*

4. *Deposit insurance is but one of many valuable subsidies enjoyed by banks, but the banking industry (and even some regulators) will never concede this point, even if it means a trade association offering $5,000 stipends for papers proving that such subsidies do not exist! Two small Oklahoma thrifts found out how valuable the deposit insurance subsidy was after they gave up their FDIC insurance and each lost about one–third of their retail deposit base.*

5. *The federal safety net, of which deposit insurance is just one component, should be minimized rather than being expanded, as is the case with the significant increase of powers (and risk exposure) allowable under Gramm–Leach–Bliley (GLB).*

6. *The federal deposit insurance system is not "broken," and any improvements to it should be relatively simple, easily understood by the public, and consistent with sound business practices.*

7. *Market discipline is always preferred to regulatory discipline, although a balance between the two must be struck.*

8. *Increased public disclosure of the financial condition of banks and thrifts is the most effective means of market discipline.*

9. *While improved regulatory discipline is desired, banks should not be subject to an undue regulatory burden that would impact their profitability and ability to compete and be responsive to customer needs.*

10. *A healthy, profitable and competitive bank and thrift industry is in everyone's best interest.*

11. *"Competition in laxity" by bank regulators undermines public confidence in the integrity of the bank regulatory and supervisory process.*

12. *Small and large banks and thrifts, including those that are still mutual operations, should be treated equitably to the greatest extent possible.*

13. *Government expenses in the regulation and supervision of banks should be scrutinized for unnecessary duplication and waste of taxpayer monies.*

14. *The best time to strengthen the deposit insurance fund is during good times, because a "pay as you go" scheme to recapitalize the insurance fund during bad times may be insufficient.*

15. *Business cycles have not been repealed, and it is only a matter of time until the next recession begins, despite the Administration unrealistic view that our record economic expansion can continue "indefinitely."*

16. *All forms of "moral hazard" by banks (e.g., in their risk profiles) or their trade associations (e.g., asking them if the DRR should be increased) regarding deposit insurance must be recognized and minimized.*

17. *The TBTF unwritten policy will always exist, regardless of banking industry or regulatory comments to the contrary.*

18. *Banks like their customers should get what they pay for and pay for what they get (including TBTF coverage).*

19. *There is considerable downside risk for an undercapitalized insurance fund but little for an overcapitalized one, as the money is "still in the bank."*

20. *Banks and thrifts must very carefully and clearly disclose which of their increasing array of products are NOT federally insured.*

RECOMMENDATIONS FOR THE DEPOSIT INSURANCE FUNDS

My major recommendations to this Subcommittee on the proffered questions regarding the deposit insurance funds are summarized below:

1. The BIF and SAIF insurance funds should be merged ASAP.

While many if not all of the remaining recommendations will generate debate, and most likely opposition from the bank and thrift industries, it is hard to imagine any basis for opposition to the merger of the BIF and SAIF funds. The arguments and broad support for this proposal are overwhelming:

A. A merged fund would eliminate any potential confusion among bank depositors as to "which fund is stronger," especially during periods when such a distinction may be made between banks and thrifts.

B. There is less and less differentiation between banks and thrifts as the strong thrifts have become banks and the weak thrifts have become history. In fact, according to the OTS, national banks hold 22% of SAIF–insured deposits, state–chartered banks hold 16%, and FDIC–supervised state savings banks hold 8%; conversely, approximately 15% of BIF–insured deposits are held by thrifts (*American Banker*, February 7. 2000, p. 4). It makes sense that an increasingly merged industry would be covered by a merged insurance fund.

C. From an actuarial perspective, a larger more diversified fund would be much stronger in terms of protecting depositors, as the potential risk exposure from the largest insured would be reduced. This is demonstrated by the fact that Bank of America's approximately 9% share of BIF–insured deposits would drop to 6% for a merged fund, while Washington Mutual's roughly 9% share of SAIF–insured deposits would fall to 2% (*American Banker*, February 7, 2000, p. 4).

D. A larger and more diversified merged fund would also be stronger in terms of managing the potential risk exposure from troubled banks and thrifts. According to *The FDIC Quarterly Profile* (Third Quarter 1999), the 69 problem banks as of September 30, 1999 had $4 billion in assets (insured deposit data are not available) represented 14% of BIF's $29.5 billion in balances. However, just 11 problem thrifts with precisely the same amount of assets ($4 billion) accounted for 39% of SAIF's $10.2 billion. Even though data unavailability precludes a more relevant apples–to–apples calculation of insured deposits of problem banks and thrifts to BIF/SAIF balances, the combined 80 problem banks and thrifts would represent a more palatable 20% of a merged fund's $39.7 billion in balances.

E. Unlike 1995 when the BIF fund was roughly three times as well capitalized as the SAIF fund, they are approximately equal, with the SAIF reserve ratio of 1.44% actually exceeding the BIF reserve ratio of 1.38%. This parity of reserve ratios as of September 30, 1999 eliminates any of the controversial issues that existed in 1995 regarding thrifts' payment of a special assessment to enter a merged fund or banks' increased exposure with a merged fund assuming FICO obligations.

F. Key regulators (e.g., OTS Director Seidman), Congressional leaders (e.g.,. Senator Gramm) and even bank trade associations (e.g., the ABA) have expressed support for this concept, although the ABA position requires the OTS to be merged into the OCC (a good idea) and FDIC excess reserves be rebated (a bad idea).

G. Academics and economists who have studied this issue generally support a merged fund. The most relevant studies have been done at

the regulatory agencies themselves. Robert Oshinsky, Financial Economist at the FDIC, concluded in a recent study ("Merging the BIF and the SAIF: Would a Merger Improve the Funds' Viability?") that "...a merger of the funds would substantially decrease the probability of a failure of at least one deposit insurance fund. In addition, it would provide benefits to both the BIF and SAIF." An OCC working paper ("Two Deposit Insurance Funds: In the Public Interest?") jointly prepared in February 1997 by an OCC economist and an FDIC economist likewise concluded that "Combining the deposit insurance funds may result in a lower probability of fund insolvency from unanticipated economic shocks than keeping the funds separate."

2. The 1.25% statutory designated reserve ratio (DRR) should be increased to 1.50%.

There is probably not one bank or thrift executive anywhere who would be expected to agree with this recommendation (or the two subsequent ones), as higher reserve ratios and premiums would cost them money. Any regulator adopting this 1.50% DRR recommendation would immediately incur the wrath of the industry. The FDIC, for example, would have to argue that there's a "significant risk of substantial future losses" to justify a 1.50% DRR instead of the current 1.25% one.

Thus, the only hope that the DRR be strengthened to a 1.50% level to afford the necessary protection that bank depositors require is with this Subcommittee. Hopefully, Representative LaFalce and others here will, as was the case in 1995, seriously consider this recommendation and ultimately make this necessary statutory change.

My 1995 testimony presented a strong case for an increase in the DRR to 1.50%. Changes in bank competition and regulatory structure, among other things, have significantly increased the insurance fund risk exposure since that time, thereby making the case for a 1.50% DRR stronger than ever.

A. Megamergers during the last decade have significantly increased the insurance fund risk exposure. Robert Oshinsky, Financial Economist at the FDIC, recently completed a working paper titled "Effects of Bank Consolidation on the Bank Insurance Fund." He found that "...based on historical loss and failure rates, the consolidation that took place between 1990 and 1997 increased the risk of BIF insolvency by approximately 50%, and that megamergers that took place or were announced during the 18 months between year-end 1997 and midyear 1999 increased the risk of insolvency further." If a 1.50% DRR made sense in 1995, it certainly makes even more sense now.

B. In addition to general megamerger trends, the increased concentration of assets in the hands of a small number of giant banks has further increased the insurance fund risk exposure. According to that same FDIC study, "... the health of the BIF has become more and more dependent on the health of the top 25 banking organizations, and future insolvency may be deeper, and harder to emerge from, than in the past." An *American Banker* story ("FDIC: Big Mergers Change Fund's Risk Calculation," September 8, 1999) about that FDIC study noted that 54.5% of industry assets at midyear 1999 were held by the 25 largest bank holding companies, compared to just 31.8% as of yearend 1990. Again, a 1.50% DRR would provide more protection to bank depositors than the current 1.25% under this environment.

C. "The little [bank failures] are never going to break you," said Roger Watson, FDIC research director. "It's the low-probability, large-institution failures" that pose the greatest risks to the insurance fund and the taxpayer according to the above–cited *American Banker* story. He also noted that there is a 12.5% or one in eight chance that BIF would be rendered insolvent if one of the top 10 banks fail. FED Chairman Greenspan recently stated that megabanks "create the potential for unusually large systemic risks in the national and international economy should they fail" (*New York Times*, October 12, 1999). According to the FDIC, just six banks (Bank of America, BankOne, First Union, Wells Fargo, Chase and Fleet/BankBoston) and Washington Mutual comprise 26.2% of domestic deposits. Another FDIC report shows that just 20 banking organizations comprise the top 50% of the industry's total assets. Such tremendous concentration of resources in the hands of a small number of banks suggests the prudence of increasing the DRR to 1.50%.

D. The TBTF implicit guarantee now covers more banking companies than ever before, again suggesting the advisability of an increased DRR. The combined funds have $39.7 billion in balances and a combined reserve ratio of 1.40%. There are, however, nearly 20 bank and thrift companies with deposits at or above the approximately $40 billion level. The TBTF coverage likely extends beyond this group.

E. Expanded investment, insurance and other powers under GLB for companies with insured bank deposits will increase the risk exposure of the insurance funds even more than was the case in 1995. Instead of just commercial banking risks, we must now consider risks in the investment banking and insurance fields. Regardless of firewalls and other precautions, a solvency problem at a nonbank affiliate may find its way to the insured bank, thus increasing the funds' risk exposure. Any such increased risk exposure will be better managed with an increased DRR, such as the recommended 1.50% one.

F. Recent bank failures have been blamed on new types of financial risks that were not common in 1995, thus suggesting an even stronger case now for a 1.50% DRR than was the case then. For example, we learned from a House Bank Committee hearing last Tuesday that participation in subprime lending, asset securitizations and fraud have been a factor in a disproportionate number of recent bank failures.

G. The recent and projected growth in insured deposits at existing and new types of financial depositories (e.g., Internet banks) likewise argue for an increase in the DRR. For example, Merrill Lynch recently announced that it will be offering federally insured interest–bearing accounts such as CDs tied to its brokerage accounts. Based on Merrill's projection that it could draw as much as $100 billion into its CDs compared with "several billion" currently, the FDIC estimated yesterday that the BIF reserve ratio would fall from 1.38% to 1.32%, compared to a softened impact on a merged fund going from 1.40% to 1.35%. This further supports the need for a 1.50% DRR and a merged fund ASAP.

H. The 1.25% DRR is inadequate as demonstrated by the fact that the FDIC fund was at a 1.24% level in 1981, prior to its dwindling to a negative number in 1991 and 1992. Had the DRR been 1.50% in 1981 (see argument below why it *should* have been), it is likely that the FDIC would not have had to publicly announce the insolvency of its fund during that period. Besides the obvious embarrassment to the FDIC, such an announcement reduced confidence in the banking system at the worst possible time.

I. An increased DRR such as 1.50% provides bank depositors with greater confidence during periods of financial stress and turmoil. We had the S&L, junk bond and BCCI scandals in the 80s and the Orange County, Mexico, Barings PLC and Long Term Capital Management collapses in the 90s. There will likely be more financial disasters this decade, and it would be more reassuring to depositors seeking a safe haven that their insurance fund had a higher DRR.

J. Financial problems and costly bank failures can occur even in the best of times as we saw last year with Keystone, the most expensive and spectacular failure in 1999. As a result, BIF reported a comprehensive loss of $113 million for the first nine months of 1999, and it is expected that this will be the case for the entire year. This would be the first year since 1991 that BIF lost money. When asked about this prospect, the FDIC's Fred Carns told the *American Banker* (November 9, 1999), "I wouldn't want to commit to a forecast, but it could be very close." With BIF likely losing money for the first time since 1991, it makes sense to talk about *increasing* the DRR. Also, the BIF reserve ratio actually *decreased* from 1.40% to 1.38% from June 30 to September 30,1999, the first such decrease in some time. Had the DRR been at 1.50% as

recommended in 1995, the FDIC would not be in this embarrassing situation of having to admit BIF is losing money for the first time since our last recession.

K. Assets of *failed* banks and thrifts have not exceeded $1 billion since 1994 until last year. Realizing the unforeseen risks in the new millenium, FDIC Chairman Tanoue testified before the House Banking Committee last week that the FDIC now projects a range of failed bank and thrift assets of $0.7–3.6 over the next two years. Using the midpoint of $2.2 billion, this means that the FDIC is projecting failed bank and thrift assets of at least $1 billion for each of the next two years. Considering the proven insufficiency of the 1.25% DRR regarding the likely BIF loss in 1999 when failed assets exceeded $1 billion, it would be prudent to increase the DRR to 1.50% so this embarrassment is not repeated in 2000 or 2001. This is especially the case in light of relatively recent legislative cost containment changes such as prompt corrective action, conservatorship at 2% capital, least–cost resolution and national depositor preference.

L. In a 98 FDIC working paper ("Capitalization of the Bank Insurance Fund") Financial Economist Kevin Sheehan used a two–state Markov–switching model to predict the impact of different required reserve ratios, ranging upward to 1.50%, on BIF solvency and fund balances. He concluded that "...increasing the required reserve ratio while maintaining the current assessment rate would substantially reduce the likelihood of small fund balances." Using data from 1972–1996, he estimated that with current assessment rates of 23 basis points, the probability that BIF would become insolvent would be only 0.9% with a 1.50% required reserve ratio compared to 3.2% for a 1.25% one. Thus, the probability of the FDIC facing the ultimate embarrassment of an insolvent fund (as was the case in 1991 and 1992) is reduced by more than three and one half times with a 1.50% rather than 1.25% required reserve ratio. This added cushion of 25 basis points in the DRR leverages itself to a substantial amount of added depositor protection and confidence in the system.

M. A better capitalized fund with a DRR of 1.50% rather than 1.25%, representing more rather than less bank equity, should promote sounder banking practices, because it is the banks' money that will be tapped first before the taxpayers are asked to support the fund.

N. A 1.50% DRR is not an unrealistic number for many reasons. *First*, it is just 10 basis point above the 1.40% level of the combined funds as of September 30, 1999, even though that ratio actually *decreased* since June 30, 1999. *Second*, the FDIC fund ended December 31, 1934, the first full year of the FDIC's existence at a 1.61% reserve ratio, a fact that should not be ignored in terms of the original intent of the FDIC.

Third, the FDIC's reserve ratio was at or above 1.50% for 10 year–end periods since 1934, the highest being 1.96% in 1941 and the most recent being 1.50% in 1963 (near the beginning of our previous post–war record expansion). *Fourth*, according to the FDIC, the DIDMC Act of 1980 specified a 30–basis point range for the reserve ratio with 1.25% as the midpoint, thus resulting in a .95–1.55% range.

O. According to the FDIC, the DIDMC Act of 1980 specified the 1.25% DRR target midpoint of this range since it was the "approximate historical average reserve ratio for the FDIC fund prior to 1980" (Confidence for the Future: An FDIC Symposium, January 29, 1998, p. 103). Using year–end reserve ratios from the FDIC's 1998 Annual Report (p. 122), the *average* such ratio for the 1934–1979 period was 1.425% rather than 1.25%. Also, the *median* reserve ratio, a more relevant statistical measure of central tendency, for that period was precisely the same 1.425%. Thus, if the FDIC's description of how this "magic" 1.25% ratio was calculated is correct, it appears from these revised calculations that someone may have ignored the "4" and read 1.425% as 1.25%. If this bizarre account of FDIC history is in fact true, the "correct" 1.425% DRR would have been rounded up to 1.45% or 1.50%, and we would not be debating the need for this increase in the first place!

3. There should be NO cap on the size of the merged fund.

The previous recommendation documented why a 1.50% DRR should be the floor rather than the ceiling for the deposit fund. In fact, an equally important recommendation, which follows from the above–listed principles underlying the bank depositors' view is that there should be NO cap on the size of the merged fund.

A. Any private sector insuring organization would stockpile reserves collected during the good times in anticipation of the bad ones. The insurance fund should be no different and allow its reserve balances to continually grow without any designated cap. Depositors would obviously have much more confidence in an insurance fund with such a conservative policy.

B. The idea of a "capless" insurance fund is not that dissimilar from a proposal advanced in 1998 by Ron Feldman, a senior financial analyst at the Minneapolis Fed. He proposed that "Banks should have to pay for deposit insurance no matter how large the reserves held by the government," according to the *American Banker* ("Minneapolis Fed Researcher: Abolish Bank Insurance Fund," October 22, 1998). He would actually abolish the insurance fund and forward mandatory insurance premiums to the Treasury. The FDIC would tap a Treasury line of credit for any needed funds, and there would be no concern over

whether or not the DRR was appropriate as there would be no fund. This approach, while clearly an unconventional one, properly identifies the Treasury and the taxpayer as the ultimate insurer of last resort for the banking system. Importantly, there would be no cap under this proposal, as all banks would pay deposit insurance premiums.

C. A "capless" insurance fund allows the reserve balances to grow to much more significant levels, thus reducing the likelihood that the DRR will be breached. Once that happens, the banking system effectively transforms to a "pay as you go" procedure, with collected (and usually increasing) assessments being used to replenish the fund. However, with depressed earnings in a slowed economy, assessments may not be sufficient for recapitalization. For example, 1987 bank earnings of $2.8 billion just exceeded failure losses of $2 billion but were well below 1988 losses of $6.7 billion. A capless fund with a much larger cushion protecting the DRR would lead to increased confidence in the system by insured depositors.

4. Rebates should NOT be paid.

The recommended deposit insurance system with a 1.50% DRR and no cap on the size to which the fund could grow would not allow rebates.

A. A capless system without rebates would obviously result in a larger and stronger fund, thereby instilling even greater depositor confidence.

B. Insurance can generally be defined as the substitution of a small certain loss in the form of a premium for a large uncertain loss. As long as banks and thrifts are protected from a large uncertain loss, they should pay for this privilege with continued assessments and no rebates.

C. The idea that insurance premiums should be inventoried as reserves for future losses rather than being returned to banks in the form of rebates is consistent with the logic of many conservative bankers. For example, many such bankers retain their earnings to strengthen capital (i.e., reserves) rather than paying earnings out to stockholders in the form of dividends. Many conservative bankers with good dividend payout ratios have substantial capital cushions. It may be apples to oranges to compare the minimum required capital ratio at an individual bank to the required reserve ratio for the entire system; nonetheless, it is of interest to note that a capital ratio of 2% results in conservatorship, but a DRR of well below that amount is considered satisfactory.

5. Good public policy regarding the insurance funds would also include the following recommendations:

A. Merging of the OTS into the OCC.

It is reasonable to assume that a merged industry with a (hopefully) merged insurance fund would likewise have a merged regulator. This recommended merging of the OTS into the OCC, which could begin with the OTS operating as an OCC division, makes sense for numerous reasons:

1. The transitional approach of the OTS initially operating as an OCC division, before an outright merger of the two agencies, would enable mutual and state–chartered thrifts the ability to continue their operations in an equitable manner.

2. The overall quality of the examining force at both the OCC and OTS will increase as a result of such a merger due to the synergistic impact of specialized professionals benefiting from working together. These advantages are most often seen in the private sector megamergers, but such economies can also benefit governmental bodies, especially those that have very similar functions.

3. Both the OTS and OCC are agencies of the Department of the Treasury (DOT), so there is already a common culture (and employer).

4. There would be a substantial cost savings to taxpayers from eliminating duplication and consolidating operations, conservatively estimated at $12 million annually by DOT in August 1993. Had that merger occurred then, there would have been some $72 million in taxpayer savings by now.

5. The OTS' five regional offices in Jersey City, Atlanta, Chicago, Dallas and San Francisco are virtually identical to the OCC's six regional offices in New York City, Atlanta, Chicago, Dallas, San Francisco and Kansas City. Thus, there would be considerable opportunity for office consolidation without the attendant employee relocation costs.

The merging of the OTS into the OCC can be viewed as a first step in a long–awaited consolidation of federal bank regulators. I have long proposed that a logical first step in this regard would be a common *compliance* function of the four federal regulators, and this could be organized through the existing FFIEC working group set up for this purpose. This shared function would result in more consistent and efficient examinations and ultimately less regulatory burden and taxpayer costs.

The concept of one umbrella regulator at the federal level has been proposed for decades now by various presidential and other banking commissions. This proposal only would make sense, however, if the federal banking agency was totally independent of the Administration.

In addition to the reduced governmental expenses and possibly regulatory burden associated with one federal bank regulator, there is the added advantage that regulatory "competition in laxity" would cease to exist.

This phenomenon apparently reared its ugly head again last week according to the *American Banker* ("Visit from Hawke Kept 'National' in Bank's Name," February 11, 2000). They reported that the $7.1 billion National Bank of Commerce (the nation's 72nd largest) reversed its decision to switch to a state charter based upon the OCC's offer to include the bank in its large–bank supervision program (usually reserved for only the three dozen largest national banks).

The most extreme step in the bank regulatory consolidation process beyond the umbrella federal bank regulator would be for the elimination of the dual banking system which has existed since the formation of the OCC in 1863. Although this proposal receives little serious consideration at the present time, it was discussed somewhat during the S&L crisis because of the federal deposit insurance costs resulting from poor state chartering and supervisory decisions.

For example, since a disproportionate share of all S&L losses were due to state–chartered thrifts in California, Florida and Texas, is it fair that taxpayers in the remaining 47 states paid an equal share of the federal bailout? This is contrary to the basic management precept that A = R or Authority = Responsibility. If the federal government has ultimate responsibility for bailouts, why shouldn't it likewise have the ultimate authority over all banks? State deposit insurance systems are a thing of the past, and all that is really left is the federal deposit insurance system.

B. Explicit recognition of the "Too Big To Fail" (TBTF) policy in the form of a special assessment for TBTF banks.

There are four TBTF facts of life, regardless of what anyone in banking or the regulatory agencies say. *First*, TBTF has existed since 1984. *Second*, TBTF cannot be eliminated. *Third*, TBTF is an extremely valuable competitive advantage and benefit to the 25 or so banks in this exclusive club. *Fourth*, TBTF banks pay nothing for this privilege.

Realizing that nothing can be done about the first three facts, this recommendation would require a special assessment on the total assets (not deposits) of TBTF banks that would be added to the overall insurance fund balances. The assessment would be on assets rather than deposits

because the potential risk exposure of the insurance fund is with the entire company not just its insured deposits. Even if this were a minor annual assessment in the 3–8 basis points range, it would result in relatively substantial balances because of the very large size of the TBTF banks.

The Comptroller of the Currency suggested that the 11 largest banks in 1984, with roughly $40 billion or more in assets in current dollars, were TBTF. There are approximately 25 bank and thrift companies with such an asset (not deposit) base. As previously noted the 20 largest bank and thrift companies, each with at least $50 billion in assets, represent 50% of the industry's total assets.

With an explicit TBTF policy, there would be the equivalent of an FDIC sticker on the lobby door, but this one would read "TBTF." And, for that privilege, these 25 or so banks will be paying a nominal annual special assessment that will benefit the entire insurance fund. These banks are already getting this TBTF benefit, but under this proposal they will be paying for it.

C. Significantly expanded *market discipline,* beginning with the *public* disclosure of some information on the safety and soundness condition of banks and thrifts.

One of the most popular market discipline proposals is the required periodic issuance of subordinated debt to ascertain the "market's" perception of the risk profile of an individual banking company. This approach assumes, however, that there exists adequate and timely *public* information about banks to enable the market to make an informed decision in the pricing of the debt.

Professor Edward Kane of Boston College recently evaluated various deposit insurance reforms proposals. He concluded that private–sector reforms cannot replace regulatory activities "until institutions are required to disclose more financial information to the public and regulators are forced to reveal problem institutions to the public sooner" (*American Banker*, May 27, 1997).

There are numerous bank rating companies such as IDC, Sheshunoff, Veribanc and Bauer. Some of these rating services provide limited data at no charge over the Internet, and others charge steep fees for their services. All of these services use the most recent published quarterly call report data as their primary source of information.

Rather than requiring depositors, customers, investors, creditors and other interested parties to seek out and possibly pay for what may be inconsistent and inaccurate ratings from these different sources, there is a better approach. The preferred approach would be for the regulators to

publicly disclose a bank's most recent safety and soundness (CAMEL or MACRO) rating and a limited public portion of the bank's exam.

Because these exam ratings can be up to a year and one–half old, an alternate and perhaps complementary approach would be for the public disclosure by the FDIC of the capital group rating (3 possibilities) and supervisory subgroup rating (3 possibilities) for each bank and thrift. The FDIC uses a three by three matrix with nine possible cells for deposit insurance assessment purposes.

It can be argued that the disclosure of the FDIC's problem bank and thrift list would be too "stampedish" and possibly harm those institutions. The disclosure of the above–suggested ratings data, however, would be the next best option, as these data do not include conclusionary statements by the regulators on the problem status or likely solvency of a given bank or thrift.

The recommended increased ratings disclosure will allow for more accurate and timely valuations of banks and thrifts by interested parties and a more efficient allocation of banking resources.

While regulatory and supervisory discipline is extremely important (see below), bank management reacts more quickly and strongly to market discipline in the form of increased public disclosure of timely and relevant information. This has already been shown to be the case with the public disclosure of a portion of the compliance exam and rating for each bank and thrift since July 1, 1990.

D. Significantly improved *bank regulatory and supervisory discipline.*

While market discipline can be significantly enhanced with increased public disclosure of bank data by the regulators, the quality of bank regulatory and supervisory discipline can only be improved through changes by the regulators themselves.

The potential benefits to the deposit insurance system of an improved bank regulatory and supervisory function are tremendous in terms of the earlier identification of problem banks and the reduction in the cost of failed ones.

Recent hearings at the House Banking Committee on last year's bank and thrift failures indicated that regulators may not have properly regulated and/or supervised several of the failed banks. Bank supervisory lapses have also been cited in recent cases where a bank did not fail but suffered internal problems, such as the alleged money laundering scheme at the Bank of New York.

FED Chairman Greenspan has recently stated that a new regulatory approach is required with megabanks and their complicated and expanding

business lines. The demands on regulators in this regard will only increase with the broadening of powers resulting from GLB.

The federal bank regulators are constantly trying to improve their work product, but there are still four different federal agencies, the most for any federally regulated industry.

The most important improvements in the bank regulatory arena would come from merged regulatory operations, such as the proposed OTS and OCC ones that should result in a more efficient and effective work force. The problem, however, is that even if the OTS and OCC are able to execute a smooth merger, the FDIC and FED are still independent agencies.

The inconsistencies and differences in procedures in examining the largest banks was made clear in the recent GAO study titled "Risk–Focused Bank Examinations" (January 2000) requested by Chairwoman Roukema. Upon reviewing the risk–focused bank exam procedures at three FED and four OCC banks, the GAO concluded that there were numerous differences in key areas such as the decentralized vs. centralized nature of the procedure, the use of resident examiners, etc.

I completed a similar study over a two–year period where I was part of a team who carefully reviewed the public portion and examiner ratings on about 1,500 exams. Although the exams involved bank compliance (not safety and soundness) matters, I likewise found tremendous disparity in the quality of bank examiners and published work product. For example, examiners at some of the 31 regions of the four banking regulators were nearly ten times "tougher" compared to examiners in other regions.

I learned that some regulators more than others were more likely to use tougher public enforcement actions such as C&D orders compared to informal and nonpublic actions. It was clear that the power of public disclosure in such enforcement actions was considerably more effective than traditional means of regulatory discipline, such as increased capital and/or risk based assessment requirements.

Assuming the experience gained from these two regulatory studies is representative of other safety and soundness examiners throughout the country, there is a pressing need for greater education and training of the bank examination forces to result in a more consistent and effective work product.

E. Significantly improved disclosure of non–FDIC insured bank products.

GLB should mean a more competitive array of banking, securities and insurance products more conveniently available to a broader segment of our economy.

Besides the potential increase in risk exposure to the deposit insurance fund from the nonbank activities, there is also the possibility that some of the public may be confused by them in terms of their FDIC coverage. This may result in even greater risk exposure to the fund if bank customers buy non–FDIC insured bank products under the assumption that they were insured.

A case in point that really struck home happened a few weeks ago when my mother–in–law called me about an unbelievable 10% CD for 24 months at a local bank. Before calling to have the funds transferred she called me to tell me about this great deal, as she knows I regularly follow local CD rates. When I saw the advertisement for the 10% CD I was likewise shocked by this great rate, even if for two years, until I read the very small print to discover that this was an UNINSURED investment note.

Even after I told her about the small print she still could not read it, until she got her magnifying glass to confirm what I said. "How can they do this" she angrily stated. Within 24 hours I got the almost identical call from my mother, but she was able to read the fine print by just taking off her glasses.

How small was this print? The "**10%**" was in a gigantic 2.75" typeface, dominating the ad, which appeared in the business section. The bank's name, which connotes federal insurance, was much smaller at only 5/16", compared to the miniscule "not insured by the FDIC" at only 1/16". Thus, the eye–catching "**10%**" was roughly 44 times the size of the FDIC disclaimer.

With the rapidly increasing proportion of senior citizens in states like Florida, special care should be taken to fully disclose the FDIC disclaimer, at least in the same typeface as the word "bank." Otherwise, there is the potential for increased risk exposure to the deposit insurance fund as duped seniors may legitimately have thought they were buying FDIC–insured products.